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Contemporary Flat-Tax Reforms in Eastern Europe: Causes of Diverse Approaches
A comparison of Slovakia, Czech Republic and Germany

Lívia Antalová
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Abstract

The paper deals with the issue of contemporary flat-tax reforms in Eastern Europe and aims to account for the different approaches that various European countries adopted towards the idea of a flat-tax. Empirically, the work is based on detailed studies of Slovakia, the Czech Republic and Germany. The analysis considers three factors being decisive for the flat-tax feasibility: 1./ party system institutionalization, 2./ coalition/opposition cohesiveness, 3./ labor union institutionalization. First, the study is concerned with each of the factor’s influence on the political decision-making process in the three country cases. Secondly, on country paired comparisons the findings for each of the countries are mutually contrasted. Although all identified factors seem to be at play with regard to flat-tax feasibility, I argue that it is either the strength or the weakness of labor unions’ institutionalization and welfare identity that underlie the political decision-making in the East and the West and as a result determine the flat-tax (un-)feasibility. The absence of welfare identity in the East allows for higher coalition cohesion in favor and weaker opposition against the flat-tax adoption in contrast to the West.

Keywords: flat taxation, tax reform, tax competition, east-west divide, CEE, labor unions institutionalization, Slovakia, Czech Republic, Germany

1 The present paper draws on the author’s MA thesis completed at the Department of International Relations and European Studies at Central European University in Budapest (2007) under the supervision of Prof. Béla Greskovits. The paper was revised and updated during the author’s work in the Special Research Program on International Tax Coordination. For encouragement and very useful comments in the revision stage I thank particularly Dr. Ilker Ataç and Oliver Prausmüller.
Introduction

The ‘flat-tax tide’ that swept through the emerging markets in Eastern Europe (EE) is emblematic of their attempts to catch up with peers to their West. The term is used to describe tax reforms in a number of EE countries that have introduced flat rates in their tax systems. The emergence of the flat-tax tide faced harsh criticism coming especially from the large states in Western Europe, most prominently Germany and France. This is largely due to the fact that the Eastern European flat-tax reforms were simultaneously accompanied by a considerable lowering of tax rates. The countries of EE were accused of ‘social dumping’ and proposals preventing them from accessing the financial resources from the Social and Cohesion funds of the European Union (EU) were put forward. The key observation informing this paper, however, is that the critical voices became loud only once such tax reforms proved politically unfeasible in Western Europe. At the same time, a closer look at EE shows that not all countries have chosen the path of adopting flat taxation and those that have, differ significantly (Keen, Kim and Varsano 2006).

What motivations lead the countries to consider implementation of the flat-tax? The fact that they were initiated in Europe by the post-communist countries is the result of the need for reform of the inefficient and complex tax systems characterized by high rate of tax evasion (black economy) the countries inherited from the previous regime. Tax evasion was a particularly problematic issue given the rising budget deficits of the post-communist countries. Also a tax reform was needed that would increase the country’s competitiveness and stimulate economic growth. Therefore, the key expectations that the new tax system was to meet were: simplification, transparency, efficiency, stability, business attractiveness. The adoption of flat-tax seemed to be the right step towards achieving all four requirements, whereas lowering the tax rates should additionally stimulate the business. What appeared particularly attractive to the Western European countries, for example to Germany, was the simplification of the tax system that the flat-tax type of reform promised. What, however, was much less appealing to Germany were the low tax rates that could hardly finance the expensive welfare state, unless a structural reform of welfare system was initiated simultaneously. Similarly, Germany was not willing to resign on the principle of progressive taxation. A seeming ‘triviality’ that could, however, impede the feasibility of flat-tax in Germany.

The present paper sets out to understand what factors can account for the flat-tax feasibility in some countries, but not others. It looks for causes of divergence in the approaches to flat taxation between Western and Eastern Europe on the one hand (Germany vs. Slovakia, Germany vs. Czech Republic), and among the countries in the East on the other (Czech Republic vs. Slovakia)? More specifically, the paper develops a comparison of the country cases and assesses the similarity of the reasons given for the (un-)feasibility of flat taxation in the East and those in the West.

Drawing on the relevant literature I will look at the flat-tax reforms (and reform attempts) in all country cases and will address the question of the feasibility of the flat-tax adoption. I propose three key aspects as decisive in the flat-tax implementation debate: 1./

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2 The flat-tax introduced in EE differed in: the level of the flat rates, flat-tax application in all PIT, CIT, VAT or exclusively in some of these, introduction of equally high flat-tax rate for all PIT, CIT, VAT or different flat rates for each of them, etc.
the political parties’ institutionalization\textsuperscript{3}\ 2./ the factor of government coalition cohesiveness and 3./ the level of the institutionalization of social actors. With regard to the social actors, the focus is made particularly on the position of labor unions in the political system and the society more generally. Such narrowing seems viable as the workers’ organizations from among all interest groups are expected to be most biased against such radical and neoliberal reforms (favoring mostly businesses) as is the flat-tax. The expectation is, the higher the political parties’ and labor union institutionalization, the less prone is a country to flat-tax implementation. Also the lower coalition cohesion appears to work rather against the flat-tax. In addition to the already mentioned factors affecting the flat-tax reform feasibility, the analysis will briefly sketch the initial conditions and motivations for the flat-tax adoption in each of the countries, in order to build an understanding of the reform impetus.

The paper is structured as follows: the first chapter offers a critical overview of the relevant literature and is useful in narrowing down the scope of my argumentation, as well as in identifying the research gap and the potential determinants affecting the feasibility of flat-tax. The second chapter deals with flat-tax approaches in the East. Using the individual cases of Slovakia and the Czech Republic the feasibility of flat-tax is being assessed based on the three factors of political parties’ institutionalization and their ability to form cohesive coalition (and opposition) and finally, the labor union institutionalization. A similar approach is used in the third chapter devoted to Germany, the representative of the West European flat-tax resentments. The fourth chapter is crucial due to its comparative analysis integrating the findings. The paired comparisons of Germany and the two EE countries suggest the persistent divergence between the old and the new members of the EU. The paired comparison of Slovakia and the Czech Republic shows a variation within the EE region. At the same time, the comparative approach will try to determine which of the studied factors plays the most decisive role in the flat-tax adoption process. The conclusion will summarize the argument and the solutions to the research question raised in the introduction.

1. Background and Literature Review

Extensive literature already exists dealing with the issue of persisting social and economic divergence between the old EU members and the new Eastern European members. Most recently, the dividing line between the two parts of the EU could be observed with regard to the perception of tax competition. Tax competition is hardly a new phenomenon and the numerous attempts on the EU/EC level, as well as under OECD auspices to regulate or harmonize the tax rates have failed repeatedly (Roháč 2006). Since the spread of the low and flat taxation in EE, tax competition and harmonization have again become pressing issues.

The authors Dehejia and Genschel (1999) address the issue of tax competition and tax rates harmonization in the EU through the perspective of economic integration. They explain the failure of international or regional collective action against tax competition by claiming that “small states can actually gain from tax competition and may be reluctant to support cooperation” (Dehejia and Genschel 1999: 405). In the debate on the EU tax harmonization it is indeed the large states that have become its traditional supporters, most prominently Germany, France and Italy. They oppose the Eastern European ‘flat-tax tide’ most harshly and accuse the EE countries of creating unhealthy tax competition

\textsuperscript{3} as suggested by O’Dwyer and Kovalčik (2007). See the Background and Literature Review chapter.
That said, the tax policy questions indeed appear to be a very sensitive issue, carefully protected especially by the countries that might most profit from tax competition.

Ronen Palan (2002) addresses the issue of low tax countries through the perspective of tax havens. He claims that “modern tax havens did not originate as part of a conscious state or firm strategy” (Palan 2002: 159). Only later have some countries used the adoption of substantially lower tax rates from average to stimulate its economic growth and development. This has also been the case of some CEE countries which used it as a “rational advantage-maximizing strategy” (Palan 2002: 159). The post-communist countries clearly recognized the immense benefits they can obtain from luring investments from abroad: new job opportunities, innovations, foreign capital. The capability to offer business friendly tax regimes in combination with relatively cheap labor, was to serve as the main enticement for FDI. The hope was to increase competitiveness of the post-communist countries in the globalizing world. Although the EE countries evidently can not be labeled as tax havens in the proper sense of the phrase, a broader definition of tax havens as “countries that have enacted tax legislation especially designed to attract the formation of branches and subsidiaries of parent companies based in heavily taxed industrial nations” (Palan 2002: 154) is fitting enough to embrace the EE countries as well. As a result, the governments of WE (mainly the German and the French one) feared that the domestically based businesses would leave their countries in search of a less costly business environment. In fact, these tax rate differentials of the states are assuming greater importance in company decision-making as the other differences between the countries within the EU diminish (Houlder 2005). The resentment of the WE developed countries was sparked particularly by the increasing unemployment rates at the domestic level but also by the inability of these countries to “clean up their own tax systems” (Barysch 2004) and substantially decrease the tax rates mainly due to the high welfare expenditures.

In his essay, John Campbell (1993) reviews and categorizes the scholarly work on fiscal sociology and develops a conceptual model of the determination of taxation. His model is shown in Figure 1 and it “seeks to explain major transformations in levels of taxation as well as the structure of tax systems” (Campbell 1993: 173). Campbell starts out with the proposition that for a tax policy change there has to be an immediate pressure, either geopolitical, fiscal and/or economic. However, as he says: “the effect of crisis on taxation is mediated in complex ways by a variety of additional factors” (Campbell 1993: 173). Among these he first identifies the pressure of social actors and interest groups on the transformation process of the tax policy. The pressure of the interest groups on the tax policy change is mediated by two other elements: the factor of political representation and the factor of the political institutional arrangement of the state.4 I shall refer to his concept later in this chapter when constructing my own model of the determination of the flat-tax adoption.

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4 Though Campbell admits that more causal variables could be added. In Campbell (1993).
In his work Campbell (1993) briefly addresses the role of the interest groups in the tax policy making process and offers a possible explanation of the unfeasibility of low corporate income taxes in unionized societies such as the German one. The author asserts that “corporate tax rates fall as organized labor becomes weaker” (Campbell 1993: 167). Going in line with his hypothesis, one might expect that the traditionally well-organized labor, with the capacity to exert political pressure, makes it increasingly difficult for a country to lower its corporate tax rates. It is a serious claim that requires deeper verification whether the variation in labor organization could possibly account for the variation in the level of taxation.

Many authors (Ost 2000; Crowley 2004; Bohle and Greskovits 2005; Vaughan-Whitehead 2003) point to the East-West divide in the labor union institutionalization. David Ost (2000) concludes the weakness of East European labor from a closer study of the tripartite structures and he talks of “illusory corporatism” (Ost 2000: 503) in EE. What he proposes is that despite the establishment of tripartite structures in the EE countries, they do not fulfill the function of effective mediation between the tripartite partners (government, businesses, labor unions). Like Ost, Stephen Crowley (2004) also ascribes the labor’s weakness to the ideological legacy of communism and questions the fact that the European social model, as promoted by the West European countries, can expand to Eastern Europe. As he says: “while labor relations in the [EE] region have indeed been transformed the result resembles American-style flexibility more than the model of ‘social Europe’ that many in the EU hope its new entrants will adopt” (Crowley 2004: 395). Bohle and Greskovits (2005) ask similar question and are skeptical about the prospects of the European social model in EE.

Contrary to the previous stream of literature, Iankova (2002) and Katzenstein (2003) take a different position concerning the organization of the industrial relations in EE. Iankova observes “spectacular mushrooming of corporatist-like institutions across the CEE region” (Iankova 2002). While some authors doubt the eastward expansion of European
social model, Iankova (2002) views the European Integration as the means to preserve and maintain social dialogue structures in the CEE region, though she admits this varies depending on the country. Katzenstein (2003) similarly argues that two processes – 1./ transformation from socialism to capitalism and 2./ the Europeanization - have served as the necessary pressure towards the establishment of social partnership and the corporatist type of capitalism. Katzenstein’s argumentation is in sharp contrast with the literature on European social divide that talks of ‘neo-liberal landscape’ (Vaughan-Whitehead 2003) spreading in EE and on which also the main argument of the present paper builds up on. In fact, I will try to show that the differences in the labor institutionalization in the West of Europe and the East can largely account for the flat-tax (un-)feasibility.

In sum, I assume the factor of labor unions’ entrenchment in society can be a valid determinant whether and what kind of flat-tax reform a country adopts. However, the most common approach among the scholars takes the EE region as a whole and broadly applies the concept of labor weakness, not accounting for the country variations. I expect this is due to the emphasis the authors put on explaining the persistent dividing line between the East and the West of Europe that has not faded away even after the collapse of communism and the accession of the CEE countries to the EU. The present paper uses the example of the two CEE countries (Slovakia and Czech Republic) to verify the proposition of labor weakness in the East compared to the labor institutionalization in the West of Europe (Germany), as suggested in the literature. This will be done through focusing on the role of the labor organizations in the flat-tax reform debate. At the same time, I claim that there are also variations in the labor union institutionalization and their capacity to exert political pressure within the East. In fact, the understanding of the ‘East European divide’ has become increasingly important as each of the countries, despite many similarities, is to follow a different, country-specific development path.

Grouping of the CEE countries into one homogenous category has been also refused by authors studying the effects of globalization on the structure of public spending (Klien, Leibrecht and Onaran 2009). Based on welfare regimes they distinguish baltic countries group and the post transition countries group (all other EU member states in the CEE region). By finding different effects of globalization on each of the groups they further emphasize the need for variations within the CEE context. The national variations in the CEE region have been particularly recognized by Bohle and Greskovits (2007). They address the institutional specificities of modern capitalisms in CEE when stating: “by the early 2000s the whole region adopted the usual standards and institutional underpinnings of economic freedom and openness in western market economies. However, there is a systematic variation in the radicalism of the reform paths leading to this outcome” (Bohle and Greskovits 2007: 446). In their work Bohle and Greskovits distinguish three types of capitalism in the region: 1./ neoliberal (the Baltic states), 2./ embedded neoliberal (the Visegrád states) and 3./ neocorporatist (Slovenia). The Baltic states’ type of capitalism is best described as being devoted to free market forces and the reduction of state interventionism in the economy. Also, “low union density, decentralized uncoordinated wage bargaining and low coverage rate of collective agreements” best describe the institutional background of the Baltic states (Bohle and Greskovits 2007: 447). The Visegrád countries’ capitalism is rather “distinguished by their search for compromises between marketisation and […] social protection” (Bohle and Greskovits 2007: 445), they did not however implement the “Western regime of protective industrial policies and generous welfare states” (Bohle and Greskovits 2007: 445). In the embedded neoliberal type of capitalism the various social groups are considered to be in a junior relationship with the elite groups and decision-
makers. Finally, the third neocorporatist model, the most similar one to the West European (or German) type, adopted in Slovenia, is characterized by an institutionally reproduced balanced pattern of the two protectionisms (both, the economic and social welfare protectionism), “whereby business, labor and other social groups are accepted as partners in shaping that balance” (Bohle and Greskovits 2007: 445-446).

The conceptual framework proposed by Bohle and Greskovits (2007) is helpful in understanding the differences between the CEE countries. The fact that flat tax (associated with the neoliberal concept of capitalism) was introduced in the neoliberal Baltic states but not in neocorporatist Slovenia is consistent with the typology presented by Bohle and Greskovits. What remains puzzling is the variation with respect to the flat tax adoption in the Visegrad group (V4) – adoption of differently radical flat tax reforms in Slovakia and the Czech Republic. This fact, I argue, calls for a more careful differentiation among the V4. On the one hand, the concept of Bohle and Greskovits provides a good explanation and justification for why there are differences in flat tax implementation between the Baltic states, the Visegrad states and Slovenia. On the other hand, it does not clearly account for the differences within the Visegrad group. I would suggest that it is dependent on the position of the countries on the ‘new capitalism’ scale between neoliberalism and neocorporatism. Also Bohle and Greskovits (2007) admit that some states stress industry protectionism while others prefer social welfare policies, the pattern of embeddedness varies across cases and over time. Thus, we can expect that greater institutionalization of labor will result in an increased resistance to flat taxation, making a country less likely to implement flat taxation. The present paper will try to position the Czech and Slovak Republics on the broad scale of embedded neoliberalism.

The variation among the EE countries is recognized and has become a crucial aspect of O'Dwyer and Kovalčík’s (2007) analysis of the reasons of the feasibility of the second-generation reforms in some EE countries but not others. Based on their study of Slovakia, Estonia, Hungary and the Czech Republic they confirm the hypothesis that the second-generation reforms “are more likely in weakly consolidated democracies in which underinstitutionalization attenuates the public’s voice in policymaking” (O'Dwyer and Kovalčík 2007: 5). In other words, the variations in implementation of flat tax, and other equally radical reforms in EE, can be largely accounted for by the level of party system institutionalization. O'Dwyer and Kovalčík view the underinstitutionalization as an 'enabling tool' helping the reform governments to undertake the radical reforms without facing much the reform inhibiting pressures from various social and political groups. As they say, this is “hard to envision in a better institutionalized democracy” (O'Dwyer and Kovalčík 2007: 5). What one has to appreciate with respect to their work, is that the authors look at the political party system also from the perspective of the opposition, stressing either its cohesion (Czech Republic) or fragmentation (Slovakia). Still, to the two factors of political parties’ underinstitutionalization and fragmented opposition, I would also point to coalition cohesion of the governments – as the possible factors affecting and explaining the feasibility of such radical reforms as flat-tax.

For the purposes of clarity, the model shown in Figure 2 summarizes the factors that I consider based on the literature overview to be the most decisive determinants of flat-tax (un-)feasibility. Namely it is the 1./ party system institutionalization, 2./ cohesion of the opposition and of the government coalition and 3./ labor union institutionalization – influence of which on the tax policy change process (specifically flat-tax adoption process) in Slovakia, the Czech Republic and Germany is carefully studied in the following chapters.
What offers at this point, is the comparison of the flat-tax determination model developed here with that of Campbell (1993). First, I adopted Campbell's logical surmise that for a tax policy reform a crisis or some other incentive is needed to motivate the governments to start out the whole process of tax reform. I similarly recognize the influence of different interest groups on the tax policy formation – however, I concentrate specifically on the role of the labor unions. As suggested previously, this is particularly interesting from the perspective of labor unions representing the most resistant group to flat-tax. Third, Campbell talks of political representation to be the next influential factor in the process of changing the tax policy what largely overlaps with the variable found in O'Dwyer and Kovalčík's (2007) paper that the flat-tax feasibility can be accounted for by the underinstitutionalized party system. Finally, the newly developed model emphasizes the cohesiveness of coalition, as well as of opposition with regard to the question of flat-tax adoption as the actual distribution of political power and influence among the actors is crucial for its adoption.

2. Flat-tax Approaches in the East

This chapter deals with the factors identified in the analysis of relevant literature as critical for the feasibility of flat-tax reform (in fact, for other radical reforms as well). On a country basis, starting with Slovakia, I will first trace the institutionalization of political parties and their ability to form cohesive coalitions, as well as the role of the opposition in the reform process. Second, I will discuss the entrenchment of labor unions in the society and their capacity to influence political decisions. A similar structure is applied to the study of the Czech Republic, which follows the section on Slovakia. Lastly, the analysis is interpreted from the perspective of flat-tax discourses in both Slovakia and the Czech Republic.
2.1. Slovakia: Feasibility of Flat-Tax

2.1.1. The Party System Institutionalization and the Coalition Cohesion

The new flat-tax reform became effective in Slovakia in January 2004. The reform was the product of the centre-right government under Prime Minister Mikuláš Dzurinda and was part of the more general package of radical second-generation reforms that the Slovak government undertook beginning in 2003. In fact, this had already been the second Dzurinda government in the row. However, the previous coalition of 1998-2002 comprised not only the centre-right political forces but also the left oriented Democratic Left party (SDL). This has in many cases inflicted discrepancies in the political program proclamations of the coalition and most likely prevented the conservative parties from passing radical reforms already in the first Dzurinda’s term.

The elections of 2002 were marked by the success of centre-right parties from which the second Dzurinda coalition government was formed. The coalition consisted of four political parties: Slovak Democratic and Christian Union (SDKÚ), Christian Democratic Movement (KDH), liberal and pro-business New Citizen’s Alliance (ANO) and finally, the Hungarian Coalition Party (SMK). These parties profited from the failure of the nationalist parties and most particularly from the communist-successor left which was caught up in numerous internal disputes and scandals (Haughton and Rybář 2004). The opposition was also formed by four parties: party of the former authoritarian Prime Minister Vladimír Mečiar the People’s Party - Movement for a Democratic Slovakia (PS-HZDS), then Slovak National Party (SNS), Slovak Communist Party (KSS) and finally, the social-democratic and populist party Smer (Direction) of the current Prime Minister Róbert Fico.

After disagreements between the coalition members in late 2003 and the departure of some coalition MPs, Dzurinda’s government could still complete its regular 4-year tenure until 2006 and that despite not being in the position of majority government anymore. What explains the peculiarity of the situation is: first, the fact that the MPs’ defections were caused more by the personal disagreements (particularly between Mikuláš Dzurinda and Ivan Šimko, the former Minister of Defense) and not by programmatic disagreements. The ‘defected’ coalition MPs were in fact reform-minded and supported the crucial governmental reform proposals. Therefore, the program cohesiveness of the coalition to implement the necessary social and economic reforms was not particularly hurt (despite the defections in seats in the Parliament). In fact, by the number of initiated and approved laws has the second Dzurinda’s government become the most effective cabinet since 1993 (Mesežnikov 2004).

The second reason that explains why Dzurinda’s minority government could complete its standard tenure, is the fact that the MPs’ ‘defections’ were common in the opposition ranks as well, leaving more space to the government to negotiate also with former opposition MPs and gain their support. According to Mesežníkov (2005), Slovak political analyst, “the opposition’s weakness, namely its inability to offer an attractive alternative to the conservative-liberal ruling coalition” (Mesežníkov 2005: 2) also significantly contributed to the durability of the weakened government. Also, the party politics

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5 The reform introduced a flat rate of 19% on all PIT, CIT and VAT.
6 Some have left their political parties to become independent MPs. This has been the case of the MPs Nemcsics, Danko and Opatrný who have left the ANO Party. Others established their own new parties - towards the end of the year 2003 a group of seven MPs left SDKÚ of Mikuláš Dzurinda and formed a new party called Free Forum (SF) the head of which became Zuzana Martináková.
discrepancies between the major opposition parties HZDS and Smer and the personal animosity between their leaders Mečiar and Fico fragmented and weakened the opposition considerably.

Though again, what should not be underestimated is the strong mobilization and dedication of the coalition members in the process of adopting radical reforms that aimed at putting an irretrievable end to the Slovak lagging behind in the reform process that has been substantially slowed down during the period of Mečiar's government (1994-1998). The coalition’s strategy since the elections 2002 was to pass the necessary reforms as fast as possible and most crucially before the accession to the EU as this would make many of the radical reforms impossible. In the case of tax reform, the process from the proposal to its approval was very short and as a result there was only limited space for open debate. Richard Sulík, the author of the idea of flat tax introduction in Slovakia and the former advisor to Finance Minister Ivan Mikloš, describes the situation in 2003 when the flat tax reform was approved:

“There has not been much time for persuading the voters. From the inception of the idea to its ratification passed less than one year…the political configuration at that time and the exceptional influence of Ivan Mikloš in the economic circles helped the adoption of flat taxation without facing lengthy debates. Based on what we can witness today, it is good it has been like that. In the Czech Republic, the debates started much sooner than in our case and the Czechs debate over it until today. We were lucky to introduce the flat tax so quickly” (Pardubský 2007: 6).

From the quality of democracy perspective, the absence of public debate over such consequential issues as is the tax reform may seem as a major infringement on the democratic process, Richard Sulík views the swiftness of that time tax reform implementation as an advantage and claims that the government did not do anything that would go against the principles of democracy: “The elite received its mandate in the elections of 2002 and the adoption of flat rate taxation was in compliance with this mandate” (Pardubský 2007: 6), says Sulík.

The previous paragraphs aimed to reveal about the state of coalition and opposition during the tax reform process. The next part deals with the political parties’ institutionalization. The most recent example suggesting the absence of institutionalized political parties and their ideological principles is the composition of the Slovak government after the parliamentary elections in 2006. The government of Prime Minister Róbert Fico was formed by three former opposition parties Smer, IS-HZDS and SNS and that despite their contrary party programs and deep hostilities between their leaders in the past. Mesežnikov is critical of the formation of a coalition between social democrats and radical nationalists that has only been possible at the expense of their substantial party program change. According to him, ”in societies with established and crystallized political parties such problems occur only rarely” (Institute for public affairs 2005: 3). Mesežnikov calls for reforms within the party politics where such flushing between two immensly distinct concepts and substantial situational modification of the party program would not be possible (Institute for public affairs 2005). This leads us back to O’Dwyer and Kovalčík’s (2007) main

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7 The first ‘Tripartite’ talks on the tax reform proposal were held on April 25, 2003, the government approved it in June 2003 and the Parliament passed the reform first on October 29, 2003 and then again on December 5, 2003 after the President Rudolf Schuster’s veto.
observation of the absence of political parties linked to clearly defined socio-economic constituencies. The quote by the Czech President Václav Klaus clearly highlights the opacity of the Slovak political parties system by comparing it to the party systems of the Czech Republic, as well as of the WE countries:

“the distribution of the political powers is not clear and easy to comprehend. On the Czech political scene you have perceptible political structure and you can classify them [parties] from left to right. You can be absolutely sure to say who is who … and it is not because of lack of interest or attention on my part. It is clear to me how to define the Austrian political scene or the German one” (Palata 2003: 1).

In fact, the political party system was marked by high volatility of the political parties since the formation of the Slovak state. On the one hand, there were parties that surprisingly quickly disappeared from the political scene (SDE, ZRS – Union of the Workers of Slovakia) and on the other hand, several new parties were formed or grouped together (SDK, SOP, ANO, SMER, SF). Apart from the weakly institutionalized multi-party system, the determination and cohesiveness of the centre-right (coalition) parties on the one hand, and the disintegrated opposition on the other, largely contributed to the feasibility of the new flat-tax reform and other radical social welfare, pension and health-care reforms in Slovakia. However, to make a comprehensive picture of the conditions under which the flat-tax reform became feasible in Slovakia, we have to address shortly the position of social actors, specifically the labor unions, in the policy-making process.

2.1.2. Labor Union Institutionalization

From what has been suggested previously we can expect to find weakly institutionalized labor unions in Slovakia in contrast to those in the West. This section will first provide us with an empirical evidence of the labor weakness and outline the possible reasons hiding behind the labor’s underinstitutionalization. In addition, this section also reveals the second Dzurinda’s government perception of the labor unions role in the reform process, as well as the labor unions’ perception of the radical reforms, including the flat-tax, undertaken by the centre-right coalition beginning 2003.

One can identify three major factors accounting for the overall labor’s weakness in Slovakia, as well as its inability to effectively temper the radical socio-economic changes of the reform process. First, there is the historical legacy of the communist regime, which largely discredited the role and the function of labor unions in the post-communist society. Further, the role of the unions was considerably weakened in the course of the transition period, when the Mečiar’s government pushed the labor unions aside. As a result, the unions joined the opposition and anti-Mečiar movement and practically helped the first Dzurinda government to come to power in 1998. Although Dzurinda’s first government improved the position of the labor unions in Slovakia, this has been largely due to the pressure of the leftist coalition member SDE that insisted on the legal establishment of the tripartite social dialogue and other socially pleasing changes. However, the role of the labor unions has been diminished again during the second centre-right government. Finally, the “large-scale privatization and the rise of startup firms including green-field investments where owners often opposed the establishment of trade unions” (Jurajda and Mathernová 2004: 16) have certainly not helped to strengthen the Slovak labor unions.
Secondly, what one has to acknowledge, is that labor unions were undoubtedly active during the term of the second Dzurinda government, however their efforts proved futile and ineffective (the unions have initiated the referendum to recall the current government or called for general strike – rather radical actions both of which failed). Their tireless and often radical activity stemmed from the absence of a viable left-oriented political party that would represent the unions’ interests at the political level. The absence of a political partner with representatives in the decision-making bodies (Parliament) also made it hard for the labor unions to push through their suggestions at the high level politics. This situation has certainly contributed to the difficult position and overall weakness of labor unions (Vaščeka 2003). The only left party represented in the Parliament was the Slovak Communist Party, however cooperation with which was unacceptable for the labor unions. Only later on, before the parliamentary elections of 2006, have the labor unions and the Smer party of Róbert Fico come together to sign an agreement as a guarantee of their post-election cooperation.

Finally, what Emil Machyna, the president of OZ KOVO, a labor union organizing predominantly workers of the metal, machinery, metallurgical and electrotechnical industries, considers as third possible reason for the labor’s weakness is its internal fragmentation (Sudor 2006). The Confederation of Trade Unions of the Slovak Republic (KOZ SR) is an umbrella organization for 35 labor unions representing workers of diverse job backgrounds. Machyna admits that this number of labor unions makes it often difficult to reach an agreement between them. To elaborate more on his point, Machyna contrasts the KOZ SR to labor organization in Germany where the overarching labor union Deutscher Gewerkschaftsbund (DGW) groups together eight trade unions only, which is certainly a paradoxical situation given the size and the overall production of Slovakia to that of Germany.8

That the labor unions displayed their dissatisfaction with the socio-economic reforms undertaken by the centre-right coalition is comprehensible as the new legislation largely liberalized the employment and cut on the social benefits. Also, as already suggested, the coalition abolished the Law on Economic and Social Partnership in December 2004, by which the influence of the labor unions and other lobbyist groups was dramatically reduced. The unions and business interest groups could from that point on evolve pressure through the Council for Economic and Social Concertation (Rada hospodárskej a sociálnej dohody - RHSD) which, however, only held an advisory function to the government with strictly defined competences and responsibilities (Government Office 2007). These events can be rightfully understood as actions by which the government dismissed the unions as a partner in the reform process (O’Dwyer and Kovalčík 2007). It seems that the president of KOZ SR Ivan Saktor recognized the boundaries limiting the possible negotiations between the labor unions and the government: “we are persuaded that presumably we will not be able to change the government’s mind on the issues declared by it in the program proclamation before the elections, meaning that the tax reform is directed towards the flat-tax adoption” (Government Office 2003). Interestingly, although taking a negative stance towards the flat-tax implementation and having strong reservations especially about the increased VAT, the labor unions – under the circumstances they found themselves in - had to accept the adoption of flat-tax and more or less take it as a given.

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8 Machyna also mentions the most recent developments in Austria where 5 labor unions got incorporated into one labor union in order to better push through their interests (Sudor 2006).
2.2. The Czech Republic: Feasibility of moderate Flat-Tax

The study of the Czech Republic is crucial for our understanding of what factors play the most decisive role in the flat-tax (un-)feasibility. The Czech flat-tax debate of spring 2007 heated up the political parties across political spectrum and although it ended up with Czech Republic joining the East European flat-tax tide, the reform was significantly more moderate when contrasted to that of Slovakia. By studying the three identified variables in the Czech policy environment and comparing the findings with the observations in Slovakia and Germany, we should be able to make predictions about the decisive variables for the flat-tax implementation. This, however, will be the subject of the fourth comparative chapter. This section, following the same pattern as the previous one, explores the political party system, as well as the labor unions entrenchment in the Czech Republic. The aim is to point to the variations within the East that, in the case studied here, also resulted in different radicalism of the tax reforms.

2.2.1. The Party System Institutionalization and the Coalition Cohesion

The debate on the urging necessity of comprehensive reforms of tax, social welfare, pension and health care system has been present in the Czech Republic for a long time. The debate has even intensified beginning 2007 due to the continuously rising government debt and budget deficit which was expected to reach the level of 4.3% of GDP in 2007 (Ministry of Finance of the Czech Republic 2007). What was, however, even more alarming than the actual current budget deficit rate was the pace of its growth. In fact, since the collapse of the communist regime the Czech tax system has not undergone a serious reform. The numerous amendments that have taken place were only partial and made the system more complicated and less transparent (according to the data there were 80 amendments of personal income tax law by 2006).

In late 2006 a new centre-right government of the Prime Minister and leader of the Civic Democratic Party (ODS) Mirek Topolánek was formed in coalition with the Christian Democratic Union-Czechoslovak People’s Party (KDÚ-ČSL) and the Green Party, though having only a fragile majority in the lower chamber of the Parliament. Already in April 2007 the government disclosed a new and relatively revolutionary proposal of reforms for the tax and social welfare system. The basis of the tax reform proposal was the introduction of flat (however, not single rate) taxation for personal incomes (PIT) at the rate of 15% and the corporate incomes (CIT) at 19% (by the year 2010). What concerns the lower VAT rate, that was to be increased from 5% to 9%, though the headline rate of 19% should have remained unchanged. When compared to the Slovak flat tax system, the variance between the two systems is evident: first, the Slovak tax reform introduced single rate for all PIT, CIT, as well as for VAT. Secondly, the rate was set at 19% which is seemingly higher than the one proposed in the Czech Republic. In reality, however, the Czech 15% PIT was “charged on gross income, which includes the employers’ social security and health care contributions” (Lomas 2007) and under the Slovak conditions this would correspond to a rate of 23%.

The comparison of the Czech reform effective as of 2008 with the Slovak tax reform of 2004 is necessary, to point to the variance in the flat tax reforms in CEE. From the two, the Slovak tax reform has been significantly more radical also when compared to the level of taxation in Slovakia prior to the tax reform. However, what might be even more interesting is contrasting the Czech tax reform proposal with the pre-election concepts of the three
coalition parties. ODS ran in the elections with the proposal of introducing a 15% flat and single rate tax on PIT, CIT and VAT. Christian Democrats wished to introduce flat tax on PIT and CIT only and the Greens were actually against the flat tax whatsoever, though wished to lower the direct income taxation and increase the indirect taxes especially on electricity, coal and gas (so called ecological tax reform). The adopted version of the tax reform seems to be a compromise of the party programs of the three coalition partners. The negotiation process between the coalition partners alone largely mitigated the original and relatively radical concept suggested by ODS and resulted in a moderate version of flat-tax reform proposal (Vašek 2007). In fact, some analysts even hesitate to call it a reform implying that the label ‘reform’ is for the cosmetic changes in the public finance a somewhat strong term. They rather propose to call it ‘fine-tuning’ (Schwarz 2004).

The political powers in the Czech Republic were at the time of tax reform adoption balanced between the left and the right. In fact, it has been early in the transition period when the two major parties on both sides of the political spectrum have been established and form a substantial part of the Czech political party system until present. Except for the Greens, who made it to the Parliament after the elections of 2006 for the first time, the Christian Democrats and the Communists are highly established political parties in the Czech political system and have been continuously represented in the Parliament since the very inceptions of the Czech Republic. In contrast to a rather volatile political party system of Slovakia, the Czech party system shows signs of high institutionalization. Throughout the year 2007 it remained puzzling for a long time whether Topolánek would be able to push through the tax reform despite the majority (although fragile) that his government disposed of in the Parliament. Such concerns were primarily based on the current position of the main opposition party and on the influence of social actors (especially labor unions). The next section looks more closely on the role of the labor unions in the Czech society and their position in the flat-tax policy debate.

### 2.2.2. Labor Union Institutionalization

The Czech sociologist Zdeňka Mansfeldová and her colleague Petra Rakušanová (2006) acknowledge in their paper the institutionalized position of the interest groups in the Czech society. They argue that the social groups, in addition to political parties, played an important role during the transfer to the market economy and claim that their importance has even increased as a result of the accession of the Czech Republic to the EU. According to the authors, from “among the large number of interest organizations and civic associations active in the Czech Republic, there are some that, because of their influence and prominent position, have permanent access to political decision-makers and that to a great extent influence the public policies” (Mansfeldová and Rakušanová 2006: 2). To this group of particularly influential social actors they assign both the representatives of labor (trade unions) and capital (employers and business organizations), though some authors (Bohle and Greskovits 2007) would certainly object that the tripartite relationship is hardly reaching the level of the neocorporatist model of Slovenia or of unions in Germany, as the next chapter will show.

There is a number of possible interpretations that can help us understand today’s strength of the Czech labor unions. In contrast to Slovakia, the Czech labor unions did not experience the marginalization that the Slovak unions have tasted during the Mečiar’s period and therefore could develop and establish themselves in society. In fact, some authors argue
that the fact that the Czech labor unions had to operate under the centre-right government until 1997 was positive in the way that they learned how to organize and negotiate about the reforms proposed by the government (Jurajda and Mathernová 2004). Though the real political power the unions seem to have gained only under the social democratic governments in the period between the years 1997/8 and 2006. The social dialogue “has been extended and institutionalized beyond the tripartite meetings” under the social democrats what has facilitated that “the influence of the trade unions shows in several policy and institutional dimensions” (Jurajda and Mathernová 2004: 88).

Another aspect that significantly sets apart the Czech unions from the Slovak ones (clearly missing a political partner) is the interrelationship of the Czech unions with the leading left party ČSSD. This close proximity is best embodied in the person of Milan Štěch who, being the President of the Czech-Moravian Confederation of Trade Unions (ČMOKS) – the umbrella organization of the Czech unions, also holds the position of Senator for social democrats in the upper chamber of the Czech Parliament (last reelected in 2008). More similar cases of (former) union representatives holding a post in the government could be found suggesting the labor unions’ influence on the policy-making. At least this has certainly been the case during the social-democratic governments. With the political turnaround after the elections of 2006 that has brought to power the centre-right forces, one should be cautious about the effect this change could have possibly had on the position of labor unions in the Czech society. Although the close proximity of the labor unions and the social democrats persisted even after the elections, meaning that the position of the unions was represented in the political decision making, it is rather questionable that they were in the position to influence the actual process of policy-making.

That the centre-right government did not seem to take much into consideration the opinion of the labor unions has been demonstrated with respect to the reform of public finance. The tripartite partners were invited to the round table only after the coalition has already agreed on the complete reform package and on the introduction of flat-tax. As the position of the Czech business groups has been, with few and less substantial remarks, rather positive, the government’s indifference has become particularly disturbing to the labor unions. The unions’ embitterment from the tripartite talks is expressed in the following quote by Milan Štěch: “We sat over something that has been already approved by the government. The commentary procedure was utterly formal and in fact nobody took notice of our reservations” (daily Mladá Fronta Dnes 2007). The Czech unions were particularly critical of the abolishment of the progressive taxation and its replacement by the flat-tax, as well as of the cuts in the corporate tax rates. They argued that this step relieves the rich and businesses and puts additional burden on the middle- and low-income groups, a traditional argument heard from the labor unions on the part of flat-tax also elsewhere. In sum, it appears that the labor unions may have lost on their political influence with the rise of the centre-right in the Czech Republic, though they still remained an institutionalized and influential social actor that together with the social democrats formed a coherent block of anti-flat-tax resentments.

As the analysis shows, the institutionalization of political parties and of the labor unions in the Czech Republic is certainly deeper than in Slovakia, what has lead to lengthy political and public debates over the Czech tax reform, and resulted in the adoption of a rather moderate version of flat-tax reform. When trying to compare the two EE cases a question arises whether it is the economic lagging behind its neighbors that made Slovakia launch a major economic reform, while it was enough for the Czech Republic to make only few cosmetic changes. Jiří Schwarz (2004) from the Czech Liberální Institut (Liberal
Institute) negates this approach and maintains that the differences in the economic indicators of both countries were not of such fundamental character, as to claim that there was no other option left for Slovakia than to undergo a radical economic and social reform. He rather sees the difference between the Slovak reforms and the Czech ‘fine-tuning’ in the politics, suggesting that every economic reform is a matter of political feasibility, which rests on a reliable parliamentary majority. This is an observation that from the three factors studied here gives credit especially to the factor of coalition cohesiveness.

3. Flat-Tax Approaches in the West

As already indicated, the flat- and low-tax tide in EE provoked numerous discussions in the West – including Germany. The reactions of the West were at first mixed: right away, France did not sympathize with such measures, while Germany acted more cautiously at first, but later on moved closer towards the French position. Conspicuously, none of the West European countries have chosen this system of taxation and although there is an urgent need for new sound tax reforms among them as well, their perception of flat taxation is so skeptical that any attempts at change in that direction would likely prove futile. The perception of flat taxation in the West can be aptly described as “fine in theory, just not practical in the real world” (Economist 2005: 11). The reasons behind this pattern constitute the main subject for discussion in this chapter. In addition, this section will also use the example of Germany to point out the fact that the critical voices in the West became loud particularly once such tax reforms proved politically unfeasible. Employing Germany as the crucial case here is compelling for several reasons: first, in Germany the flat-tax debate not only reached the highest level of political decision making, but it was also considered by the leading political party as a potential cure-all for the complex and arguably inefficient German tax system. Second, Germany is an excellent example of a dramatic turnaround from attempts at implementing flat-tax to direct refusal of such measures. This chapter follows a pattern similar to the previous one and approaches the study of flat-tax (un-)feasibility through the perspective of the domestic political situation and the strength of the political and social actors, as well as through the perspective of the distribution of the pro- and anti-flat-tax forces in the society.

3.1 Germany: Unfeasibility of Flat-Tax

Three major categories of foreign reactions to Slovak tax reform depending on the aims and interests pursued by these groups can be identified. First, it is the experts’ viewpoint, which is based on the evaluation of the reform from the perspective of economic efficiency and social sustainability endorsed organizations like the OECD, IMF, World Bank or the European Commission. This group generally assesses the reform positively. The second type of response is the already mentioned private sector, represented primarily by businesses leaders and foreign investors, who evaluate the reform using their preferred criteria of the openness and quality of the business environment. As the Slovak reform resulted also in a decrease in corporate tax, apart from being flat, their reaction was also positive. Finally, but crucially for the purposes of this paper, it is the political leaders in the
West evaluating the reform, “while pursuing their political aims. They express opinions on foreign reforms that are in line with the intentions of their domestic political agenda” (Krajčír and Ódor 2005: 78). This is the moment where the reactions of Angela Merkel (CDU), the current German Chancellor, can be aptly fitted in.

Before the Bundestag elections in September 2005 the Christian Democratic Union (CDU) introduced in its election campaign the idea of flat-tax as one of the crucial solutions to the German economic problems and tax complexities. At this time, Merkel had praised the Slovak tax reform, as the outcomes that it had produced in this small East European economy were in line with Merkel’s political aims. However, soon after the Slovak-inspired proposal entered the German political arena, it encountered strong domestic opposition. Merkel backed out and switched positions in what the experts on German politics explain as her defense of German national interests (EurActiv 2005). As a result, the political course of the new German government in the tax policy was accompanied with a revised position towards Slovak tax reform, as the previous position did not correspond with the home-grown political agenda. At the same time, it is important to recognize the fact that in the neo-liberal circles in Germany the flat-tax captured great interest as it would provide solution to the current complicated tax system. However, the reality showed that the idea proved politically unfeasible in German society.

Merkel’s turnaround and the later resentment of the Slovak reform can be understood only in the context of the domestic situation and flat-tax discourse in Germany. The peculiarity of the situation indicates that there were significant domestic pressures opposing the idea of flat-tax. However, that Germany needed a new, sound, and most importantly transparent tax reform is beyond dispute. And why should not a tax system that helps EE countries, which surely were in a more troublesome situation than Germany, to overcome their problems inherited from the past work in Germany? What conditions made the system of flat- and low-rate taxes unfeasible here? – that is the conundrum I hope to be addressing in the following sections.

3.1.1. Political Parties’ Institutionalization and Coalition Incoherence

In trying to solve the puzzle of the flat-tax unfeasibility in Germany, one should start by addressing the issue from the perspective of the political parties involved in the policy- and decision-making process. The political party system in Germany is based on two major “cross-class parties with a record and reputation of support for the country’s welfare state” (Kitschelt and Streeck 2003: 26) – CDU, SPD. What needs to be emphasized here is particularly the aspect of social inclusiveness that both parties are committed to. This often implies preserving the status quo and refusing any radical reforms changing the institutional and socio-economic character of the German environment. In fact, any major party that dared to touch them or promised to do so, was doomed to failure in the next election (Kitschelt and Streeck 2003: 26). Some authors suggest that this has also been the case in the election of 2005 when the preferences for the flat-tax initiating party (CDU) sharply declined, once their tax proposal was made public (Tagesspiegel Online 2005).

As mentioned previously, the flat-tax was proposed, as in the previous two country cases, by the centre-right party CDU, or more specifically by Paul Kirchhof\textsuperscript{9}, and brought

\textsuperscript{9}Professor Paul Kirchhof was the initiator of the flat-tax idea in CDU and for that matter also in Germany, setting the flat-tax rate at the level of 25 % for all PIT, CIT and VAT. In fact, he was nominated by Angela Merkel as the prospective Minister of Finance, in case CDU wins the elections.
about extensive debates across the political spectrum. Both SPD and the Green Party resolutely refused the flat-tax implementation as a substitute for the existing progressive taxation. In fact, the only party that was ready to support the flat-tax proposal was the FDP (Free German Party), the traditional coalition partner of CDU. Though, as the following analysis will show, the approaches of even the flat-tax proponents have not been unequivocal (CDU) or have changed over time (FDP) and largely contributed to the ultimate failure of the flat-tax.

One of the crucial aspects that have certainly had a negative effect on the outcome of the flat-tax debate in Germany was the split on the flat-tax issue within the Merkel’s CDU party itself. Actually, it is not a recent problem that the party has been divided in the left and the right wing balancing between the two concepts. Therefore, it is not surprising that a critique of flat taxation comes from CDU’s own left-wing ranks as well. Norbert Blüm was a Minister of Work and Social Affairs (1982-1998) in the cabinet of Helmut Kohl and in his contribution to *Süddeutsche Zeitung* he regrets that the Union “got infected with the neoliberal epidemic” (Blüm 2005). He complains that the flat-tax contradicts the basic concept of the Christian-social theory which is the concept of justice. Several other examples of such defections in thoughts can be observed also at the chairmanship level of the CDU and CSU, as well as in the ranks of the Länderministerpräsidenten (from CDU/CSU).

There is one other aspect that has contributed to the failure of the flat-tax implementation in Germany and can equally be attributed to the Christian Democrats, specifically to their wrong strategy. The last minute introduction of such a radical change in a crucial area as is the tax policy before elections partly resulted in the loss of credibility of CDU. Two concepts – the official one of the party keeping the tax rates between 12 and 39% on the one hand and the one of Kirchhof on the other – created confusion among the voters. Also Merkel’s personal change in attitude from support for one concept to the other contributed to even greater turmoil. Even the only allied partner on the tax issue - FDP - showed signs of hesitation with regard to flat-tax implementation after its unacceptability to so many groups became obvious. The CDU leader Merkel tried once to play with liberalism but it proved unsuccessful and so she got back on the track of the social tradition of the Union (Germis 2006). It appears that the German soil was not ready for the flat-tax idea of the “visionary” – as Kirchhof was sometimes called. This is what Kitschelt and Streeck call a ‘German disease’ and give a precise description of the whole situation: “Cases like this, in which an experimental search for new solutions at the ground level is narrowly circumscribed or altogether outlawed in the name of equality and social protection, abound in the German system” (Kitschelt and Streeck 2003: 29).

With regard to the dissenting position of the major political rival party (SPD), the major objections of the left relied on the arguments of the flat-tax being unjust, unsocial and financially unsustainable. Interestingly, the German translation of the term flat tax - the *Einheitssteuer* - does not give the impression of the Anglo-Saxon modernity that the English term might suggest. On the contrary, it actually implies a superficially egalitarian policy in which all citizens pay the same amount of money not reflecting the level of personal incomes. This perception, suggests that people with higher incomes pay the same taxes as those with lower incomes sounding largely unfair especially to people with lower incomes. This apprehension proved to be one of the sources of discontent among the people, as well as fertile soil for political argumentation of the SPD, the Greens, and the labor unions. Some SPD politicians even did not hesitate to call the flat-taxation a *Primitivsteuermodell* (i.e. primitive tax model) (Hamburger Abendblatt 2005).
Following the identification of possible explanations of the flat-tax failure within the scope of the political party system in Germany, this paragraph will look more closely on the distribution of the political power between these political parties. The parliamentary election of 2005 has brought with itself very unusual results with several coalition options open. Due to lengthy negotiations, the government coalition was formed only several weeks after the election by the two largest parties CDU and SPD. The formation of Grand Coalition emphasizes the peculiarity of the election results, as this has been only the second time in German history that the two major parties got together to form the government. Due to the lack of government’s cohesiveness and permanent resistance of the SPD towards the introduction of flat-tax (especially of the new Minister of Finance Peer Steinbrück from SPD), as well as its stronger bargaining position, the coalition finally abandoned the idea of \textit{Einheitssteuer}. In fact, the protest against it happened to be an official declaration of the big coalition demonstrated also in the coalition agreement (Koalitionsvertrag 2005: 73). There are two possible explanations of the bargaining strength of SPD: first, CDU paid a high price for securing the chancellorship and secondly, based on the election outcome SPD had more coalition alternatives open and could easily form even a minority government (Proksch and Slapin 2006). Contrary to the low cohesion of the coalition, the political, as well as social opposition was primarily negative towards and relatively united on the issue of flat-tax.

Nevertheless, after the refusal of flat-tax introduction (which was clearly perceived as a direct ‘threat’ to the principle of progressive taxation), the issue of taxation especially then the reform of CIT became one of the central projects of the Grand coalition. Being aware of the need to increase the competitiveness of German economy the coalition agreed on a rather significant reduction of corporate tax rate from 25 to 15% coming in force with the CIT Act of 2008. The overall tax burden of corporations was thus reduced from ca. 39 to 30% (in addition to CIT, trade tax and solidarity tax have to be counted in to measure the overall burden of corporations) (F.A.Z. 2006: 13). With a simultaneous increase of indirect taxation (VAT) the changes in structure of taxation remind of the trends present in EE with one significant difference that the taxation of individual’s incomes remained strictly progressive (from 14 to 45%) and the lowered CIT rates could hardly compete with those in EE.

3.1.2. Labor Unions and Welfare-Identity Embeddedness

The flat-tax reform plan has become only one of many reform proposals - aimed at reshaping the German state to face the continuously changing external challenges - that were, however, doomed to a failure in the German socio-political environment. The resentment towards the reform in Germany has been the subject of interest to numerous studies in an attempt to identify the possible factors for its ‘reform stagnation.’ Kitschelt and Streeck (2003) see the main impediment to reforms in the German overcommitment to the institutions created in the past to secure the mutual recognition of interests of the political, corporate and social actors. The “unshakeable tripartite consensus with business and labor” (Kitschelt and Streeck 2003: 1), the functioning welfare state and the disposition to compromise have always been something that the German politicians were proud of. Though, as Kitschelt and Streeck claim, “what used to be a virtue of stability may have turned into the vice of stagnation” (Kitschelt and Streeck 2003: 4). Currently, Germany is experiencing a cyclical recovery what according to the IMF experts should be utilized by Germany for adopting the necessary structural reforms and for reducing debt (IMF 2007).
Notably, however, Kitschelt and Streeck are rather skeptical about German ability to overcome the “high equilibrium trap” (Kitschelt and Streeck 2003: 1) in the near future.

The previous section on the political parties institutionalization in Germany has documented the commitment of the two leading political parties SPD and CDU (though more the former than the latter) to the traditional concepts of German politics, such as corporatism, welfare state and the social market economy. Therefore, following the Kitschelt and Streeck’s (2003) argument, the political parties can be identified as the first group of actors making the old German institutions alive to this day. Into the second group of actors committed to the old institutions, resistant towards novelties and as a result, impeding the adoption of necessary reforms, I would place the German labor unions (though not the social actors as a whole, as the representatives of business seem to be more biased towards change and reform process, especially in the economic and labor market sphere). According to Cox (2001) the German labor unions have often used the idea of security in their argumentation, “depicting reforms as promoting insecurity” (Cox 2001: 495) and as a “way to undermine their viability” (Cox 2001: 495). As he says, this has also been the case in the 1980s when Germany failed to emulate its neighbors Denmark and the Netherlands in the adoption of radical welfare reform. The lack of labor unions’ support weakened the coalition for reform and prevented the government to pass the welfare reform, despite the strong parliamentary support. What followed, was an adoption of numerous piecemeal changes. The case explored by Cox is analogical to the German attempts of flat-tax implementation. As Angela Merkel did more recently, in the 1980s Helmut Kohl “quickly abandoned the idea of turnabout” (Cox 2001: 490) when faced with vigorous domestic opposition.

The industrial relations in Germany are very well established and the labor unions well institutionalized with a strong bargaining position. The Chancellor Merkel herself acknowledges their role in the policy-making process and has “interest in strong labor unions” (Frese 2005). On the other hand, the government also acknowledges the need for structural reforms. What according to Cox (2001) is necessary in this seemingly stalemate-like situation, is the creation of ‘social construction of an imperative,’ which means that in order to make the reform process politically feasible in Germany, the reform-minded government has to first overcome the skepticism towards reform process and novelties in general, as well as persuade the societal actors, including labor unions, of the importance of reform.

In sum, the objectives of this chapter were 1.) to focus on the example of Germany on the political party system and its institutionalization, 2.) to examine the nature political divisions among the main parties and their ability to build coalition/opposition for/against the flat-tax adoption and finally, 3.) to look at the the labor unions’ position on flat-tax and their role in German society. From the above analysis of the German case we can conclude that the country has strongly institutionalized political parties, with CDU and SPD being the most dominant ones. With regard to the flat-tax issue, the government coalition was rather split and weak, at last completely abandoning the idea. On the contrary, the opposition cohesiveness against the flat-tax has proven to be rather high. What concerns the labor unions, but the social partners in general, they traditionally enjoy influence in affecting policy (including tax policy) change. This has largely been possible by the welfare-identity embedment in German society.
4. Comparison of Slovakia, the Czech Republic and Germany

This section is crucial due to its comparative analysis integrating the collected findings. In the examination above I proposed three key variables as decisive for the flat-tax implementation and the Table 1 summarizes the findings of the feasibility variables for each country case. An attempt was made to develop a typology that would clearly structure the country conclusions. The section is organized as follows: 1./ it sums up the findings by the feasibility variables - not by country variable at this point – in order to emphasize the variety, as well as different significance of each of the factors in the countries. At the same time, it allows for an easier comparison of each variable’s influence on the political system. Then 2./ the section uses the method of country paired comparisons and determines which of the studied factors play the most decisive role in the flat-tax adoption process.

Table 1: Flat-tax feasibility factors – the three country typology.

<table>
<thead>
<tr>
<th></th>
<th>Political Parties’ Institutionalization</th>
<th>Labor Union Institutionaliz.</th>
<th>Coalition/Opposition Cohesion</th>
<th>Flat-Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slovakia</td>
<td>Low</td>
<td>Low</td>
<td>High/Low</td>
<td>Yes</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>High</td>
<td>Medium</td>
<td>Medium high/ Medium high</td>
<td>Yes</td>
</tr>
<tr>
<td>Germany</td>
<td>High</td>
<td>High</td>
<td>Low/High</td>
<td>No</td>
</tr>
</tbody>
</table>

Note: state of the variables during the time of flat-tax adoption in the case of Slovakia and the Czech Republic/ and refusal in the case of Germany

Starting with the political parties’ institutionalization variable, there seems to be a high degree of variation between the countries. Slovakia, from the three country cases has the least established party system. It is marked by high volatility in terms of frequent emergence and disappearing of the parties and by the absence of the linkage to clearly defined socio-economic constituencies (i.e. programmatic discrepancies not being an obstacle in the inter-party cooperation). On the other hand, the other EE country case, the Czech Republic, shows signs of high institutionalization with two major political parties on both centre-right and centre-left (ODS and ČSSD respectively). On this factor, the Czech Republic is rather congruent with political party system of Germany, where the two major cross-class parties CDU and SPD are an integral part of the German political scene ever since the WWII. However, there is one important aspect differentiating these parties from the Czech quasi two-party system, namely the commitment of both German parties to a welfare-identity.

In contrast to the party system institutionalization, Slovakia ranks first with regard to coalition cohesion during the time of flat-tax reform approval. At the same time, the coalition encountered only a fragmented and highly incoherent opposition – a combination of factors that to a large extent contributed to the political feasibility of flat-tax in Slovakia. On the other hand, the Czech Republic boasted only a somewhat coherent governing coalition. Although the coalition could agree on the flat-tax reform proposal, its partial incoherence and the slightly different programmatic goals of its members mitigated the
radical character of the proposal. With respect to opposition cohesiveness, the two EE countries show rather divergence. The Czech Social Democrats represent a relatively strong opposition force against flat-tax with an additional support of labor unions. Though, the opposition is hardly reaching the German level of resentments. In Germany the low programmatic cohesion of the coalition after the elections (‘Große Koalition’) predisposed the flat-tax proposal as a joint government project to its failure. In addition to SPD’s resistance (which basically meant having an opposition within the coalition), the anti-flat-tax camp was supported by labor unions, the position of which is well embedded and widely accepted in German welfare society.

The study of Slovakia and the Czech Republic further confirms the notion of labor union weakness in Eastern Europe compared to the West European case of Germany. At the same time, the analysis shows variations within the EE region, leaving Slovakia with weaker labor unions lacking the capacity to evolve pressure on the decision-making bodies. Some authors might, however, object that the unionization rate is in fact higher in Slovakia than in the Czech republic (Feldmann 2006: 838). Although the unionization rate tells us about the mobilization level of the labor unions in each of the countries, it does not tell us anything about their actual capacity to exert political pressure. The Czech labor unions indeed found themselves in a better position during the tax reform policy making process partly because of the previous social democratic governments and their extension of the cooperation with labor unions beyond the tripartite meetings. Also, the interrelationship of the unions with a leading political party distinguishes the Czech labor unions from those in Slovakia. Finally, Germany disposes of the most institutionalized labor unions with influence on the political decisions. One can claim that the welfare identity embedded in the German polity largely favors the position of labor unions. With regard to the labor unions, we must take note of the fact that labor leaders across the three countries studied here, jointly protest against the flat-tax implementation. Their line of reasoning most commonly rests on the argument that flat-tax brings inequality to the tax system and favors the wealthy, as well as the private business sector, while putting additional burden on low- and middle-income groups.

After summarizing the findings by the factors highlighting especially the variations between the countries (East vs. West, East vs. East), the next section uses the method of country paired comparisons to determine which of the studied factors plays the most decisive role in the flat-tax adoption process. For Slovakia and Germany all factors, including the outcome, are of opposite value and therefore, although this pair-comparison gives us an idea of what factors actually matter, the major shortcoming is that it does not tell us which of the three variables is the most decisive one.

On the other hand, the comparison of the Czech Republic and Germany is more telling. Here the method of difference can be applied. The political party institutionalization is similarly high in both countries. What concerns the coalition cohesion, it is rather low in the two countries. Although it might appear that it is little higher in the Czech Republic than in Germany because of two reasons: First, in the Czech Republic the coalition could finally agree on the joint flat-tax proposal, although under the less radical conditions than originally planned and secondly, in Germany the flat-tax idea was totally unacceptable for the ‘big coalition’ partner SPD. More specifically, when taken from the point of view of the voting procedure in the lower chamber of the Czech Parliament, the Topolánek’s coalition had to rely not only on all the MPs of the coalition parties, but also on the votes of two undecided MPs who ‘defected’ from the ČSSD opposition party, what clearly is not a sign of a coherent coalition. Still, I would not dismiss the coalition cohesion as an unimportant factor here.
be fair, as the Czech government succeeded in passing through the reform, the coalition then had to dispose of some effective, although limited, power. What seems to be decisive, however, is the level of labor union institutionalization, although being higher in the Czech Republic than in Slovakia, it still remains far under the level of the workers’ organization in Germany. The high labor institutionalization in Germany, as well as the omnipresent welfare identity, seem to account for the unfeasibility of flat-tax in Germany. The lower level of labor institutionalization in the Czech Republic accounts for flat-tax implementation in the country but rather in a less radical form not ‘exploiting’ all opportunities the flat-tax type of reform is offering (primarily simplicity). When applying this finding to Slovakia, its low level of labor union institutionalization clearly supports the concept developed here. Therefore, what seems to account for the variation between the East and the West with regard to flat-tax issue, is the labor unions, understood as a key link to the welfare identity embedding the society.

When contrasting the three studied variables for Slovakia and the Czech Republic, what appears to be decisive here is the factor of coalition and opposition cohesion. In the case of labor union institutionalization the difference is obvious and the level lower in Slovakia than the Czech Republic. However, although the Czech labor unions seem stronger, their institutionalization is hardly reaching the German level in their capacity to dramatically influence the decisions of the governments. With regard to party system, its institutionalization shows rather opposite values. Though, I would question its decisive impact on the flat-tax feasibility. Of course, the political parties predispose and form the governments but the Czech political parties can equally come together (as they have also proved) and agree on the flat-tax implementation like the less institutionalized parties in Slovakia. The more convincing explanation seems to be that the coalition and opposition cohesion is the decisive factor in the two Eastern European cases.

Conclusion

The aim of this paper has been to account for the different approaches that various European countries adopted towards the idea of a flat-tax. More specifically it weighed several factors that make the feasibility of flat-tax possible in some countries but not in others. Furthermore, it has attempted to elucidate, whether it is only one particular variable that accounts for most of flat-tax feasibility, or whether several variables are in the play simultaneously instead. Empirically, the work is based on detailed studies of Slovakia, the Czech Republic and Germany.

As the analysis has revealed, feasibility of the flat-tax can largely be ascribed to political variables. Whether the flat-tax debate results in its adoption or its rejection, depends largely on the current combined strength of the political forces in favor of the flat-tax. Considering the puzzle of intra-regional variation in Eastern Europe in more detail, we have to conclude that it is the combination of numerous variables in each of the countries creating a context-specific political situation that is variously supportive of flat-tax reform. The three variables - 1./ party system institutionalization, 2./ coalition/opposition cohesiveness, 3./ labor union institutionalization - identified in the literature on the subject as factors most likely to affect flat-tax adoption, indeed seem to play an important role in flat-tax feasibility. One underlying variable, however its opposite values, seem to account for the political (un-)feasibility of the flat taxation in the East and the West. This conclusion
confirms the widespread notion of the persistent East-West divide. In fact, it simultaneously confirms the social divide between the East and the West, in more particular.

In the case of Germany the study identified labor unions’ influence and welfare identity for that matter, as the decisive variables for the flat-tax unfeasibility. The idea of security and tripartite consensus underlie the political decision-making in Germany, making the country less (flat-tax) reform prone. The relative labor unions’ weakness in both Slovakia and the Czech Republic (though weaker in the former than the latter) does not allow us to make similar conclusions for Eastern Europe. Here I claim that it is rather the factor of coalition and opposition cohesion that is decisive. Nevertheless, it is the absence of German type welfare identity in EE that lets us make such conclusion. In fact, it is this absence of welfare identity that allows the EE countries form more flat-tax prone coalitions. The presented country cases have confirmed our hypotheses set in the introduction that the higher the political parties’ and labor union institutionalization, the less is the flat-tax politically feasible. This is interesting because even if some countries considered the adoption of flat-tax by virtue of its economic effects, it proves politically unfeasible. The German case also confirmed the expectation that lower coalition cohesion works against the flat-tax adoption. At last, to verify my conclusions, further paired comparisons of the non-flat-tax countries from Western Europe and both flat-tax and non-flat-tax countries from Eastern Europe are required.
References


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